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No. 85-674

In the Supreme Court of the United States

OCTOBER TERM, 1985

KENTON MEADOWS COMPANY, INC., ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the distribution of assets by the corporate petitioner to the individual petitioner constituted the termination of a business qualifying as a partial liquidation under Section 346(b) of the Internal Revenue Code of 1954 although the activity to which the distributed assets related was not a separate trade or business.

2. Whether, in any event, the distribution failed to qualify under that Section because the corporate petitioner did not distribute all of the proceeds from the sale of the assets.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-7a) is reported at 766 F.2d 142. The opinion of the Tax Court (Pet. App. 9a-35a) is unofficially reported at 53 T.C.M. (P-H) ¶ 84,379.

JURISDICTION

The judgment of the court of appeals was entered on June 26, 1985, and rehearing was denied on July 23, 1985 (Pet. App. 8a). The petition for a writ of certiorari was filed on October 18, 1985. The juris-

diction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Sections 346 and 355 of the Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)), as they existed during the tax years at issue are set forth in the Appendix, *infra*, 1a-6a.[1] The relevant portions of Sections 1.346-1 and 1.355-1 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) are set forth at Pet. App. 57a-67a. The relevant portions of the proposed amendments to Treasury Regulations Sections 1.346-1 and 1.355-3 are set forth at Pet. App. 68a-70a.

STATEMENT

At all times relevant herein, individual petitioner Kenton Meadows (Meadows) was the sole shareholder of corporate petitioner Kenton Meadows Company, Inc. (the Company). Before 1972, the Company engaged in heavy construction and related activities, including pipeline construction and maintenance, asphalt paving, quarried stone sales, road and bridge construction, and equipment rental. The Company's pipeline business was concentrated in the construction of "cross-country" gas pipelines (Pet. App. 2a-3a).

In 1970-1971 the Company had a shortage of liquid assets and, as a result, experienced difficulty in securing the bonding necessary to obtain pipeline construc-

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[1] The current requirements concerning partial liquidations are in Section 302(e). In their statutory appendix (Pet. App. 53a-57a), petitioners reproduce the current versions of Sections 346 and 355, which have no relevance to the instant case.

tion contracts. To remedy this situation, Meadows transferred 150 shares of personally-owned bank stock to the Company, receiving 550 shares of Company stock in return. Meadows' basis in the transferred bank stock was $84,350. This transaction enabled the Company to obtain bonding for a major cross-country pipeline project. The Company completed this project by the end of 1971 (Pet. App. 3a).

In 1972, unable to locate additional cross-country pipeline work, the Company decided to sell certain pipeline-construction equipment known as "sidebooms." The Company sold seven sidebooms between January and March, 1972, for which it received a total of $238,234. This $238,234 was used to retire "pipeline-related debt" that had been collateralized not only by the sidebooms but also by multipurpose equipment that the Company retained. After 1972, the Company did not perform any cross-country pipelining work, although it continued to work on smaller "station" pipelining jobs. Pet. App. 3a-4a.

Also in 1972, the Company transferred the 150 shares of bank stock back to Meadows in redemption of the 550 shares of Company stock that it had previously transferred to him. At the time of this redemption (January 14, 1972), the fair market value of the bank stock had increased to $107,000 (Pet. App. 3a).

On audit, the Commissioner treated the Company's distribution of the bank stock to Meadows as a dividend to him (ordinary income), and thus increased Meadows' 1972 income by the $107,000 value of the bank stock. The Commissioner also increased the Company's income by $22,650, which reflected the amount of the appreciation of the bank stock while in the Company's hands (Pet. App. 19a).

In the Tax Court, petitioners contended that the distribution of the bank stock was part of a partial liquidation of the Company under Section 346(b) of the Internal Revenue Code, and thus that, by virtue of Section 331(a) of the Code, it resulted in only a capital gain to Meadows—a gain measured by the excess of the fair market value of the bank stock over his basis in the surrendered shares. The Tax Court, however, rejected petitioners' contention. It found that the distribution satisfied neither of two prerequisites to the applicability of Section 346(b)—(1) termination of a *separate* trade or business; and (2) distribution of *all* the assets, or proceeds from the sale of the assets, of the terminated business. It thus upheld the Commissioner's determination that Meadows had received a dividend in the amount of the value of the bank stock (Pet. App. 19a-32a). The court also sustained the Commissioner's determination that under Section 311(d)(1) of the Code the Company's income should be increased by $22,650 (Pet. App. 32a-33a).

The court of appeals affirmed. It held that to satisfy the "separate trade or business" requirement of Section 346(b) the corporate activities in question must have been operated under some form of separate supervision and control, and it agreed with the Tax Court that petitioners had "simply failed to carry their burden on this factor" (Pet. App. 4a-6a).[2] It further held that the Tax Court's decision

[2] Although the court of appeals deemed "questionable" (Pet. App. 5a) the Tax Court's finding (Pet. App. 24a n.15) that cross-country pipelining did not produce a substantial part of the Company's combined corporate income, that finding was merely an alternative ground for the Tax Court's inference of a lack of a "separate trade or business," and the court of ap-

was, in any event, correct because the Company had not distributed *all* of the proceeds of the sale of its cross-country pipelining assets: the proceeds of the sale of the sidebooms had been used in part to retire debt for which other equipment that the Company retained had served as collateral (Pet. App. 6a-7a).

In a petition for rehearing filed in the court of appeals, petitioners advanced, for the first time, their current contention that proposed amendments to the Treasury Regulations under Sections 346 and 355 had abrogated the "separate trade or business" test of Section 346(b). The court of appeals denied petitioners' petition for rehearing without comment (Pet. App. 8a).[3]

ARGUMENT

The decision of the court of appeals is correct and does not conflict with that of any other appellate court. Accordingly, the petition for a writ of certiorari should be denied.

1. During the tax years at issue, the definition of "partial liquidation" was contained in Section 346 of the Code.[4] Section 346(b)—the subsection at issue here—provided in essence that a distribution quali-

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peals' questioning of that finding was, accordingly, not dispositive.

[3] Thus, in this case, there is no lower court opinion discussing the main legal issue that petitioners raise here. This Court normally declines review in such situations. *NLRB* v. *Sears, Roebuck & Co.*, 421 U.S. 132, 163-164 (1975).

[4] Pursuant to changes made by the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248, § 222, 96 Stat. 479), partial liquidations are now governed by Section 302(e), rather than Section 346; the current provisions are closely similar to the ones involved here.

fied as a partial liquidation if, *inter alia*, the following requirements were met:

> (1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution * * * [and]
>
> (2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution * * *.

As the above statutory language indicates, the corporation in question must have been engaged in the conduct of at least two separate trades or businesses, since there must have been at least one business that was terminated and at least one business that was continued in operation. See *Mains* v. *United States*, 508 F.2d 1251 (6th Cir. 1975); *Blaschka* v. *United States*, 393 F.2d 983 (Ct. Cl. 1968).

For the definition of "trade or business," the Regulations under Section 346 (26 C.F.R. 1.346-1(c)) incorporate by reference the definition of "trade or business" in 26 C.F.R. 1.355-1(c). This latter section defines a trade or business as—

> a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such groups must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. * * *

From this definition of "trade or business" the courts have developed a two-part test for determining whether any given group of activities constitutes a "separate trade or business." Under this test, a group of activities constitutes a "separate trade or business" where it both (1) produces a substantial part of the combined corporate income, and (2) is under some form of separate supervision and control. See *Mains* v. *United States*, 508 F.2d at 1257-1258; *Blaschka* v. *United States*, 393 F.2d at 989-992; *Krauskopf* v. *Commissioner*, 53 T.C.M. (P-H) ¶ 84,386, at 1507 (1984).

In the case at bar, the Tax Court (Pet. App. 24a n.15, 26a-27a) and the court of appeals (Pet. App. 5a-6a) correctly found that there was "no evidence of any separation of supervision and control of the purportedly separate cross-country pipelining business" (Pet. App. 25a n.15).[5] Accordingly, it is plain that the Company's termination of its cross-country pipeline business did not constitute the termination of a "separate trade or business" as required for partial liquidation treatment under Section 346(b).

2. Petitioners rely for their conflict claims on the case law and proposed regulations under Section 355 of the Internal Revenue Code of 1954—not Section 346. Their reliance is misplaced, because the two Sections deal with entirely different subjects. While Section 346 deals with partial liquidations, Section 355 provides for the separation, without recognition of gain or loss to the shareholders, of one or more existing businesses formerly operated by a single corporation. Petitioners' contention assumes that be-

[5] Petitioners do not challenge the accuracy of this concurrent conclusion by both courts below; they contend only that it was irrelevant.

cause Section 355 does not contain a separate business requirement, neither does Section 346. This is simply incorrect.

Neither the statutory language nor the legislative history of Section 355 indicates that tax-free treatment under that Section may be denied to an otherwise-qualifying transaction on the ground that it represents the division of a "single" trade or business.[6] By contrast, both the wording of Section 346 (b) and the legislative history thereof make it plain that the existence of two or more separate businesses is a prerequisite to that Section's application. Specifically, paragraphs (1) and (2) of Section 346(b) by their terms require both the termination of one business and the continuation of one business, and

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[6] Prior to 1964, the Commissioner, relying on Section 1.355-1(a) of the Treasury Regulations, had taken the position that Section 355 applied only where the corporation in question had conducted two or more separate businesses, *i.e.*, that it did not apply to the division of a single business. After suffering losses in *Coady* v. *Commissioner*, 33 T.C. 771 (1960), aff'd, 289 F.2d 490 (6th Cir. 1961), and *United States* v. *Marett*, 325 F.2d 28 (5th Cir. 1963), however, the Commissioner reversed his position and announced, in Rev. Rul. 64-147, 1964-1 Cum. Bull. (Pt. 1) 136, that he would follow *Coady* and *Marett* "to the extent they hold that section 1.355-1(a) of the Income Tax Regulations, providing that section 355 of the Internal Revenue Code of 1954 does not apply to the division of a single business, is invalid." Accord, Rev. Rul. 75-160, 1975-1 Cum. Bull. 112. The Commissioner in 1977 accordingly issued proposed amendments to the regulations under Section 355 that made it clear that the separate business rule was being abandoned for purposes of Section 355 (42 Fed. Reg. 3867 (1977)). Neither the rulings nor the proposed amendments contain any suggestion that this abandonment of the separate business rule applies to Section 346 as well.

the Senate Finance Committee Report explains that paragraphs (1) and (2) of Section 346(b) "contemplate that the distributing corporation must be engaged in the active conduct of *at least 2 businesses* which have been actively conducted" for the statutory period (S. Rep. 1622, 83d Cong., 2d Sess. 262 (1954) (emphasis added)).

The commentators similarly distinguish between these two sections. 2 S. Surrey, W. Warren, P. McDaniel & H. Ault, *Cases and Materials on Federal Income Taxation*, at 501 (2d ed. 1980) ("[w]hile the division of a single business may be accomplished under section 355, section 346(b) contemplates the existence of two separate trades or businesses"); J. Chommie, *Federal Income Taxation* 592 n.84 (2d ed. 1973) (although the courts have refused to limit Section 355 to situations where a corporation operated two or more distinct businesses prior to the separation, that result is one "hardly likely to be reached under section 346(b)"); Burke & Parker, *Partial Liquidations Under Section 346: Planning, Problems and Procedures*, 24 Baylor L. Rev. 1, 37 (1972) (unlike the situation under Section 355, to which the *Coady* case (note 6, *supra*) applies, it "is clear * * * that a prerequisite of Section 346(b) is the existence of two or more separate businesses, since one business must be terminated and one business must be continued in operation after the distribution in partial liquidation").

Further evidence that the conflict asserted by petitioners between the case at bar and those decided under Section 355 does not exist is provided by the Sixth Circuit's decision in *Mains* v. *United States*, *supra*. *Mains*, like the instant case, involved Section 346(b), and, in applying that Section, the Sixth Circuit in 1975 used the same "separate trade or busi-

ness" test that the lower courts used herein—the test that petitioners contend had been abrogated in 1961 by the Sixth Circuit in *Coady* v. *Commissioner*, 289 F.2d 490. In its *Mains* brief the government pointed out that cases interpreting Section 355 were not on point,[7] and the Sixth Circuit apparently accepted that proposition: it concluded that Section 346(b) was inapplicable to the transaction at issue because there had been no separate trade or business, without mentioning *Coady* (508 F.2d at 1257-1258).[8]

As petitioners point out (Pet. 7), a proposed amendment to the Regulations under Section 346

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[7] The Government's brief stated (at 31 n.10):

> This Court has previously declined to follow * * * [a] portion of the Treasury Regulations under Section 355 which would limit the application of that section to the separation of two or more existing businesses. *Coady* v. *Commissioner*, 289 F.2d 490 (1961), aff'g *per curiam*, 33 T.C. 771 (1960), and the Internal Revenue Service has announced that it will follow that decision (as well as the similar decision of the Fifth Circuit in *United States* v. *Marett*, 325 F.2d 28 (1963)). Rev. Rul. 64-147, 1964-1 Cum. Bull. (Part 1) 136. Unlike Section 355, Section 346(b) on its face envisions the existence of two separate businesses, one of which is terminated, and the legislative history is equally clear as to the statutory intent in this regard. Moreover, neither *Coady* nor *Marett* questioned the validity of Section 1.355-1(c) of the Regulations, which we submit clearly fall within the range of permissible administrative construction of the statutory provisions here in question. See *Bingler* v. *Johnson*, 394 U.S. 741, 744-751 (1969); *United States* v. *Correll*, 389 U.S. 299, 306-307 (1967).

[8] Similarly, *Blaschka* v. *United States*, 393 F.2d at 989-992, refused to apply Section 346(b) because there was no separate trade or business, without referring to the previously decided cases interpreting Section 355 upon which petitioners rely.

(26 C.F.R. 1.346-1(c)) cross-references a portion of the proposed amendments to the Regulations under Section 355. But that cross-reference is solely to the definition of "active conduct of a trade or business" in the proposed amendment to Section 1.355-3(b)(2). This definition is essentially a restatement of the definition contained in current Regulations Section 1.355-1(c). In patricular, the proposed amendment contains the same "every step" requirement[9] that was applied by the courts below (Pet. App. 5a, 25a), and that petitioners allege has been abandoned (Pet. 8, 12, 14, 15). Thus, the proposed amendments to the Regulations are entirely consistent with the instant decision.

3. In any event, the alternative ground relied upon by the courts below (Pet. App. 6a-7a, 29a-32a) provides ample independent support for their decisions. In order to qualify under Section 346(b), the distribution in question must be of all of the assets of the terminated business, or, if the assets are sold, of all of the proceeds from that sale. *Gordon* v. *Commissioner*, 424 F.2d 378, 385-387 (2d Cir.), cert. denied, 400 U.S. 848 (1970).[10] Here, the Company

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[9] The "every step" requirement means that if the activities in question are to be considered "trade or business" they must include every operation which forms a part of, or a step in, the process of earning income or profit from such activity.

[10] Thus, at the very least, petitioners' reliance on Section 346(b) assumes that the only assets of the terminated business were the sidebooms and the contributed stock. But the Tax Court noted (Pet. App. 29a) that other construction equipment used in the company's cross-country pipeline activities was not sold. That court thus properly concluded that "[w]e do not think that the sale of assets which occurred in this case is of the type contemplated by section 346(b)" (*ibid.*).

sold the sidebooms used in cross-country pipelining, but did not distribute any of the proceeds. Instead, it used the proceeds to retire corporate debt—debt that was collateralized not only by the sidebooms but also by other equipment that was used in other corporate activities and that was retained by the Company (Pet. App. 7a, 31a-32a).[11] Petitioners do not here question the correctness of the reliance by the courts below on this alternative ground. For this additional reason, the judgment below does not warrant review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[11] To the extent the proceeds of the sale of the sidebooms were used to retire debts collateralized by equipment retained by the company, those proceeds were in effect reinvested in the company.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)):

SECTION 346. PARTIAL LIQUIDATION DEFINED.

(a) *In General.*—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562(b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) *Termination of a Business.*—A distribution shall be treated as a distribution described in subsection (a)(2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business

which has been actively conducted throughout the 5 year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

* * * * *

SECTION 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General rule.*—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporation are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * * *

(b) *Requirements as to Active Business.*—

(1) *In general.*—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is en-

gaged immediately after the distribution in the active conduct of a trade or business.

(2) *Definition.*—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired

only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

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